Investment Highlights

Western Asset US High Yield Sector

Key Takeaways

- The Bloomberg US High Yield 2% Issuer Cap Index returned 3.53% in the second quarter.
- Spreads tightened by 57 bps in the second quarter to 290 bps and the YTW decreased to 7.06%.
- Both CCC rated and B rated bonds outperformed the index, returning 4.01% and 3.62% respectively, while BB rated bonds returned 3.44%.
- High-yield issuance totaled $77.3 billion for the quarter, bringing YTD issuance to $145.6 billion (13% higher QoQ and 12% lower YoY).
- High-yield funds saw outflows of -$0.1 billion for the quarter, bringing YTD flows to $7.1 billion (compared to inflows of $5.5 billion for the same period a year ago).
- We are still seeing opportunities in rising-star candidates and will selectively utilize the primary market at attractive concessions.
- We maintain a deep bias to cyclicals given strong fundamentals and attractive yield pickup versus noncyclicals, along with key overweight positions to financials and E&P companies within the energy sector.

Market Review

During the second quarter, increased volatility was marked by geopolitical shocks and macro crosscurrents. The market saw bouts of risk-off sentiment, most notably following the "Liberation Day" tariff announcement on April 2 and the brief US, Iran and Israel conflict. Markets subsequently rebounded as most tariffs were delayed, and Iran and Israel agreed to a tentative ceasefire. Despite these shocks, US Treasury (UST) yields twisted steeper as the front end of the yield curve declined while long-end yields rose on concerns of rising deficits and potential inflation reacceleration. Risk assets had a strong performance as the S&P 500 Index broke a new record and fixed-income credit spreads tightened.

US job growth accelerated in May. Nonfarm payrolls rose by 139,000 jobs, stronger than April's downwardly revised gain of 120,000 (from 185,000). However, the unemployment rate remained steady at 4.2%. Inflation data continued to soften over the quarter. Over the last three months, the year-over-year (YoY) core Consumer Price Index (CPI) data fell from 3.10% to 2.80%. Core Personal Consumption Expenditures (PCE), which excludes food and energy prices and is the Federal Reserve's (Fed) preferred measure of inflation, declined from 2.80% YoY to 2.70% YoY.

The Fed kept its policy rates unchanged at both the May and June Federal Open Market Committee (FOMC) meetings at 4.25%-4.50%. The latest Summary of Economic Projections (SEP) indicated that the median FOMC committee member expects two 25-basis-point (bp) cuts by the end of 2025 and one further cut in 2026. May inflation data proved slightly weaker than expected, which, combined with a downward revision to the 1Q25 GDP reading, saw UST yields fall and investors discount additional easing from the Fed. By the end of June, markets expected 67 bps of policy rate cuts by year end, up from 55 bps at the beginning of the month.

Within the high-yield market, spreads tightened by 57 bps to end the second quarter at 290 bps, based on the Bloomberg US High Yield—2% Issuer Cap USD Unhedged Index. The yield-to-worst of the index decreased to 7.06%. Both CCC rated and B rated bonds outperformed the index, returning 4.01% and 3.62%, respectively, while BB rated bonds returned 3.44%. The broad index returned 3.53% during the period. The top-performing industries were transportation and technology, while energy and banking were the worst-performing sectors. High-yield issuance totaled $77.3 billion for the quarter, bringing year-to-date (YTD) issuance to $145.6 billion (12% lower YoY). High-yield funds saw outflows of -$0.1 billion for the quarter, bringing YTD flows to $7.1 billion (compared to inflows of $5.5 billion for the same period a year ago), according to JPMorgan.

Outlook

US government policy has caused severe volatility in fixed-income markets over the last several months. Global growth is expected to slow given heightened unpredictability but should remain positive. US growth is downshifting due to a myriad of factors including tariff uncertainty, waning benefits from immigration and reduced government spending in recent years. A significant fiscal boost from European defense and German infrastructure spending should support eurozone growth and provide relief from tariff-related uncertainty. Deflationary pressures in China persist and confidence is weak amid property market concerns, but sentiment is improving with fiscal stimulus and policy easing. Overall monetary policy remains restrictive, and we believe that central banks will continue to cut rates. The Fed remains well positioned to provide support if the US economy falters.

Public debt levels continue to rise and yield curves may steepen further given concerns over fiscal policies. While we retain a modest overweight to interest-rate duration, we are concentrated in shorter maturities and biased to select countries and regions such as core Europe and the UK. While fundamentals remain positive, spreads are at the tight end of historical ranges in some sectors and warrant caution. We will continue to look for further periods of volatility to add to spread risk.

An actively managed high-yield strategy yielding near 8% remains attractive compared to equities and other higher-volatility alternatives given the current macro backdrop. Today's spreads offer a material premium in excess of default risk. Our expectations for default rates are similar to last year—about 4% on an issuer-weighted basis and 1%-2% less on a par-weighted basis. Leverage and interest coverage ratios for high-yield issuers have shown resilience, with healthy balance sheets and conservative management team behavior evident as growth slows. From a technical perspective, we expect continued demand to persist from both institutional and retail investors as they search for steady income generation in their portfolios. This recent bout of heightened volatility induced by an aggressive approach to trade policy by the Trump administration has only made the risk/reward case stronger for an actively managed allocation to below-investment-grade credit. We are still seeing opportunities in rising-star candidates and will selectively utilize the primary market at attractive concessions. In terms of industry positioning, we maintain a deep bias to cyclicals given the yield pickup versus noncyclicals and the strong fundamentals we are seeing there, along with key overweights to financials and E&P within the energy sector.

Risk Disclosures

All investments involve risks, including possible loss of principal. Fixed-income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed-income securities falls. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Asset-backed, mortgage-backed or mortgage-related securities are subject to prepayment and extension risks. High yield bonds are subject to greater price volatility, liquidity, and possibility of default.

The **Bloomberg US High Yield 2% Constrained Index** is a component of the U.S. Corporate High-Yield Bond Index, which covers the universe of fixed-rate, non-investment-grade corporate debt of issuers in non-emerging market countries. It is not market capitalization-weighted; each issuer is capped at 2% of the index.

Bloomberg US High Yield—2% Issuer Cap USD Unhedged Index is an issuer-constrained version of the flagship US Corporate High Yield Index, which measures the USD-denominated, high yield, fixed-rate corporate bond market. The index follows the same rules as the uncapped version, but limits the exposure of each issuer to 2% of the total market value and redistributes any excess market value index wide on a pro rata basis.

The **Consumer Price Index (CPI)** tracks prices for a basket of more than 80,000 goods and services.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings discussed are based on a security's rating as provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd., and they typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. The credit quality of the investments in a fund's portfolio does not apply to the stability or safety of the fund. These ratings are updated monthly and may change over time. Please note that the closed-end funds have not been rated by an independent rating agency. Investment-grade bonds are bonds t hat are rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality. A below-investment-grade bond or high-yield security has a rating of BB or lower; it pays a higher yield to compensate for its greater risk.

The **Fed Funds Rate** is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight.

Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

High-yield bonds possess greater price volatility, illiquidity and possibility of default.

Investment-grade bonds are generally rated BBB and above.

The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.

Spread refers to the difference between Treasury securities and non-Treasury securities of similar maturity but different credit quality.

Summary of Economic Projections are released by the Federal Reserve four times a year. SEP features the Federal Open Market Committee (FOMC) participants' projections for GDP growth, the unemployment rate, inflation and the appropriate policy interest rate.

U.S. Treasuries are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

Yield to worst (YTW) is based on a portfolio's current holdings on one specific day, is gross of all portfolio expenses, and is calculated based on assumptions that prepayment occurs if the bond has call or put provisions and the issuer can offer a lower coupon rate based on current market rates.

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